

# THE RICHEBÄCHER LETTER

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The economy in its entirety must continue to decline so long as more is being consumed than produced, and some part of consumption therefore takes place at the expense of the existing capital stock.

— F.A. Hayek, *Money, Capital and Fluctuations*, 1984

## WHEN STATISTICS LIE

It is widely perceived that with its “mild recession” in 2001 and the following “brisk rebound,” the U.S. economy has again manifestly proved its wonderful resilience and flexibility. This assessment is mainly based on two popular statistical measures of economic performance — inflation-adjusted GDP and productivity growth.

We hold a diametrically different view. Our assessment starts with the recognition that in recent years, the U.S. economy has been treated with the most opulent monetary and fiscal stimulus in its own history and also in comparison to the rest of the world. And what did people in America get out of all that artificial stimulus? It is, actually, America’s worst recovery by far in jobs and income since World War II or the Great Depression.

Over the 11 quarters since the end of the recession in the fourth quarter of 2001, total real private wage and salary income is up 3.9%. This compares with an average increase of 18.2% over 11 quarters for all postwar recoveries. By this measure, U.S. economic growth was far slower than that in the eurozone.

Unusually poor growth of employment is the one major negative determinant of the extremely poor real income growth from wages and salaries. Yet there are two others: *first*, the prevalence of temporary workers and low-paying jobs; and *second*, decelerating wage growth coinciding lately with accelerating consumer price inflation.

Nevertheless, all the talk is about the U.S. economy’s wonderful performance over the last few years. The key measure for this rosy perception is inflation-adjusted, so-called “real” GDP growth, up 10.4% from 2000–04. The convenient main explanation for the unusually poor employment performance in the face of sturdy real GDP growth is booming productivity growth. Firms have raised their efficiency at such a rapid rate that they have been able to fire many of their workers.

Superficially, this explanation may seem plausible, as productivity is defined as output divided by employment. Yet it is grossly at variance with past American experience, and also with current experience in the rest of the world. Actually, most other industrialized countries, including some with rapid productivity gains, have been enjoying pretty strong employment growth. In the eurozone, it is up 3.1 million. America’s miserable employment performance since 2000 is the great exception in the world. Why?

There is an alternative explanation: America’s real GDP numbers are grossly overstated, due to substantially understated inflation rates. As we have pointed out many times in past letters, the Bureau of Labor Statistics, in measuring U.S. inflation rates, is systematically using a variety of extraordinary devices that altogether add up to substantial deductions from the actual inflation rate.

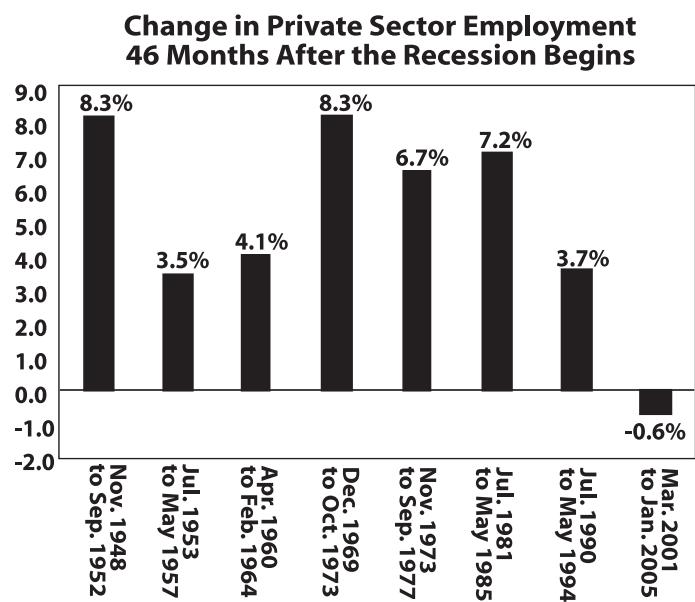
Understating the inflation rate implicitly means that real GDP growth, and in line with it, productivity growth, is commensurately overstated. In past letters, we have repeatedly addressed this subject. This time, we have done a comprehensive investigation.

There is a widely held view in the United States that productivity growth is the most important source of a

general rise in living standards by boosting incomes and profits. But where are these effects in today's U.S. economy? What has been the economic reality in the United States in the past four years, with real GDP growth of 10.4% and an increase of overall real wage payments by 3.9%?

At any rate, it is the worst employment performance on record for the United States in the postwar period, and also the worst in the world. We owe the following details and the chart below to the Economic Policy Institute in Washington.

Since the start of the recession, 46 months ago (March 2001), the U.S. economy has added a negligible 62,000 jobs. Private-sector employment, however, is still down 703,000, contracting by 0.6%.



Though the job numbers improved in 2004, the growth rate for nominal hourly earnings — 2.6% — was the lowest in the history of this wage series, which began in 1964. At the same time, consumer price inflation accelerated from 1.9% in the prior year to 3.3%.

Last year, this pattern of decelerating wage rate growth versus accelerating inflation rates led to the first inflation-adjusted decline in hourly wages since 1993. Over the four years since 2000, average weekly earnings have edged up overall by a paltry \$1.08, to \$276.70. That is an increase by a fraction of 1% over a period of four years.

## THE PRODUCTIVITY SPIN

There are many puzzles about the reported stellar productivity growth. Why has it so sharply accelerated after the investment bust in 2001? During the three following years, it hit a miraculous 4.3% per annum, up from 2.5% during 1995–2000.

*First, to state the obvious: What truly matters about productivity growth is not the number as such, but the underlying improvements in the economy such as output, competitiveness, profit and wage growth, inflation and business investment.*

Observing no such improvements in the United States, the trumpeted U.S. productivity miracle has always been just another pure statistical propaganda spin to us. Where, for example, is the big gain in competitiveness? Look at the trade deficit disaster.

Yet this mantra of stellar productivity growth has served one important purpose: It has been crucial in creating the prevailing global perception that the U.S. economy's performance is vastly superior to all other industrialized countries. It even serves to put a highly positive touch on the disastrous U.S. employment performance of the last few years.

We have vehemently objected to this productivity story for years. For us, it was flatly incompatible with the macroeconomic fact that consumption has drastically expanded over the years at the expense of productive investment and foreign trade. Essentially, this lowers productivity growth.

Meanwhile, there have been other provocative challenges of the productivity hype from influential sources: Goldman Sachs in March 2004, Deutsche Bank in November 2004 and most recently, from the think tank of McKinsey & Company.

## **THINK MACRO**

Any reasonable economist should, first of all, be aware of the inherent serious measuring problems and of substantial differences in productivity calculations between the United States and Europe. The 1995 *Economic Report of the President* commented on this: “*Roughly speaking, official measures of average labor productivity are calculated by dividing the nominal output of a given sector by an estimated price index and a measure of hours worked. The trends in all three of these variables are subject to measurement errors.*”

At the time, this was written to question the accuracy of the uncomfortably low U.S. productivity numbers. Nevertheless, it is principally true. For us, America’s protracted poor productivity growth at the time had its obvious major cause in insufficient business capital spending.

Since Adam Smith, it used to be a truism among economists of all schools of thought that lasting productivity growth has a single paramount source: a high rate of capital investment — that is, investment in factories, machinery and equipment, commercial buildings, etc.

For a long time, it has struck us as odd that American economists see the most important source of productivity and profit growth in wage cuts. For somebody with a little knowledge of macroeconomics, this is another utter fallacy.

***In fact, there are always two different ways to reduce labor costs. Firing labor is the favorite American way. The other one, traditionally widely practiced in Europe and Japan, is investment in labor-saving machinery, essentially premised on sufficient saving.***

Rightly, the old economists regarded productivity growth primarily as a function of capital investment. Accordingly, they focused on this aggregate. What is more, in the first instance, it creates jobs, income and tangible wealth from the demand side when buildings, plant and equipment are produced. Next, with their installment, all these capital goods create new employment, incomes and productivity growth from the supply side, including repayment of debts incurred for the investment.

Conspicuously, and for obviously compelling reasons, there has historically always been a very high correlation between the levels of saving and capital investment — the two essentially going together — and the level of productivity growth.

American statisticians and economists want to make us believe that America is a new-paradigm exception in this respect, being miraculously able to generate unprecedented productivity growth with zero savings and record-low fixed business investment. The consensus readily believes it. For us, this is macroeconomic rubbish.

As always, the old economists are our teachers. Convinced that productivity growth has its main source in capital investment, their attention centered on the latter, wasting little or no thought on productivity growth as its effect. In his monumental classic *Business Cycles*, Joseph Schumpeter does not mention productivity with a single word.

For American economists, “innovation” and “information” are the magic words that explain the U.S. productivity miracle, making any further investigation superfluous. To us, they explain nothing. The old economists, by the way, discarded “innovation” as a temporary and random case of productivity growth deserving no particular consideration.

Even in the case of innovation, though, the associated volume of capital investment is of crucial importance, because its volume determines the immediate effects on employment and incomes. How much employment and wage growth does the production of computers contribute?

## **THE HEDONIC SPIN**

What else, then, has the ability to create strong productivity growth? In short, appropriate statistics. So-called “hedonic pricing” has been a major device in this respect. In essence, it converts quality improvements into price reductions. The statisticians at the Bureau of Labor Statistics have done this in recent years with abundance, thereby helping policymakers with amazingly low inflation rates and, in the same vein, highly impressive real GDP and productivity growth.

The device of hedonic pricing was first introduced for computers in the late 1980s. Given exploding gains in computer power, the implicit price reductions had sweeping effects on three aggregates: high-tech investment, real GDP and productivity growth. Accounting for less than 1% of nominal GDP, business spending on computers generated up to 40% of real GDP growth at times.

In 2004, U.S. firms altogether spent \$484.3 billion on new information technology, as against \$467 billion in 2000. Within this total, computers accounted for \$101.4 billion in 2000 and \$110.8 billion in 2004.

In current dollars, business spending on computers rose a trivial 9.4% over four years. But in real terms, inflated by hedonic pricing, computer investment soared more than 10 times as fast — by 113.4%. Of course, this contributed substantially to the reported stellar real GDP and productivity growth.

In the early 1990s, press reports began to suggest that America’s consumer price index (CPI) was significantly overstated. If corrected, it was argued, it would decelerate government expenditures on entitlements tied to the CPI, and this would significantly reduce the budget deficit. The most ardent and prominent proponents behind the scene were Michael Boskin, then chief economist to the first Bush administration, and Alan Greenspan, chairman of the Federal Reserve.

Nothing happened until Clinton took over the White House. Until then, CPI was measured using the costs of a fixed basket of goods and services.

In due time, it led to the vocation of the Boskin Commission, given the task to investigate the overstatement of inflation. With its final report, the commission revolutionized inflation measuring in the United States. First of all, it promoted hedonic pricing for many more goods. From an article by Bill Gross of PIMCO Bonds, we learn that today, no less than 46% of the weight of the CPI comes from products subject to hedonic adjustment. Only recently, Mr. Boskin wrote in an article that the BLS will further “improve” its measurement of inflation in this way.

Another novelty recommended by the commission was the so-called “substitution effect.” It implies that, for example, when steak gets too expensive, the rational consumer will substitute cheaper poultry for the steak. Accordingly, poultry replaces steak in the CPI calculation. Of course, this reduces the inflation rate.

In the same vein, fixed arithmetical weighting of the CPI components was shifted to a flexible geometric weighting, automatically giving a lower weighting to CPI components with rising prices and a higher weighting to those with falling prices. The underlying assumption seems to be that rational consumers tend to buy more of what is cheap.

This means that U.S. real GDP growth since 2000 was no higher than that of the eurozone. Probably, it was somewhat lower. We realize that most people will flatly repudiate this as completely foolish. For us, the miserable performance of employment and the corresponding real income growth fully confirm this assumption. It has to be realized that the measurement of inflation, and in its wake, productivity growth, allows enormous latitude for creative accounting.

## **THE HOUSING SPIN**

Everybody knows that America has sharply rising house prices. Very few people are aware that in the last few years, housing has played an important role in lowering the recorded rate of consumer price inflation.

The basic cause of this abnormal divergence is that the general run into homeownership, spurred by record-low interest rates and surging house prices, has increasingly weakened the market for rented housing. The national rental vacancy rate jumped from 7.8% in the fourth quarter of 2000 to 10.2% in the fourth quarter of 2003. Rents are therefore rising unusually slowly.

But what does this have to do with the costs of homeownership? The fact is that in January 1983, a time of sharply rising house prices, the BLS abandoned its “asset price method” to measure changes in the costs of owner-occupied housing. Instead, it implemented the so-called “owners’ equivalent rent of primary residence” to measure changes in these costs.

Effectively, the consumer price index contains two rent components: rent of primary residence (actual tenants’ rent) and owners’ equivalent rent of primary housing (fictive rent for owner-occupied housing). Accounting together for 28.4% of the consumer price index, they clearly weigh heavily in its calculation, to which owner-occupied housing contributes 82%. Last year, it went with an increase by 2.2% into the overall consumer price index, which rose 3.3%. Mysteriously, the GDP deflator edged up only 2.15%.

It was an article entitled “Decomposing Inflation” in the *Economic Review, First Quarter 2004* of the Federal Reserve Bank of Atlanta that induced us to undertake this detailed study of the U.S. GDP deflator calculation. This article criticized the deflation scare in mid-2003, pointing out that the drop of CPI core inflation from 2.8% in November 2001 to 1.1% in December 2003 had accrued mainly from two specific items — rent and prices of used vehicles — and that their decline had its direct cause in the extremely low interest rates.

In short, soaring homeownership, depressing rents for housing, leads to the unusually slow rise in housing costs in the consumer price index. A similar case concerns the prices of motor vehicles. Aggressive sales incentives provoke temporary surges in purchases of new cars. These, in turn, drive down the prices of used cars in the wholesale market.

Pointing out that rents and car prices had accounted for two-thirds of the decline in core inflation during 2002–03, the authors of the article concluded that the two price changes had nothing to do with “deflation.”

Their concern was the effect of these demand distortions on the consumer price index. Our concern is the effects on the GDP deflator and, consequently, upon the reported real GDP and productivity growth in playing a key role in creating the global perception of the U.S. economy’s superior growth performance.

We ought to stress, however, that our long-held doubts about the accuracy of the real GDP and productivity numbers has its deeper cause in their grotesquevariance with the miserable employment and wage numbers. It is a conspicuous novelty in history that productivity growth ravages employment and associated income growth from wages and salaries. The norm is that it creates strong employment in the capital goods industries.

## **THE PROFIT SPIN**

Normally, strong productivity growth goes together with higher real wages. In the United States, the exact opposite is true. Alternatively, it ought to show in sharply higher profits. But this, too, has not happened.

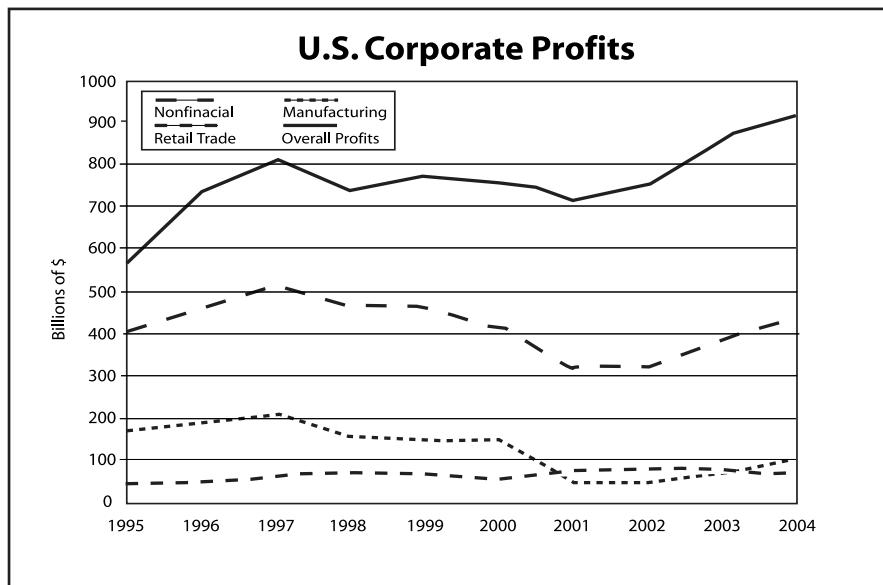
All through last year, it was Wall Street’s hype story for investors that U.S. businesses were reaping fabulous profit improvements from rigorously cutting their costs. The figure mainly causing the excitement was the aggregate of all profits: profits (before tax) with inventory valuation adjustment.

It had slumped from a peak of \$812.3 billion in 1997 to a low of \$681.3 billion in the fourth quarter of 2001. The following recovery catapulted it to a record high of \$940.6 billion at annual rate in the second quarter of 2004. Under the given economic conditions of subdued economic growth, this 38% gain was, indeed, miraculous.

Actually, the profit gains were so unbelievably miraculous that they ought to have caused more critical scrutiny than was found. To the scrupulous observer, at least two extraordinary profit sources were obvious: higher prices on inventories and huge financial gains from exploding carry trade. Realizing this, we focused on the profit development in different sectors of great importance for economic activity.

In fact, the profit differences among the sectors are outrageous. In contrast to most American economists, we attach central importance to the manufacturing sector. Its virtual devastation is obviously America's key structural problem.

Considering the profit development since the peak in 1997, the reality is a rather poor performance. While Mr. Greenspan and Wall Street were crowing about a productivity and profit miracle in the late 1990s, the government's own figures showed a profit decline, having started in 1997, at the height of the boom.



The best objective measure of profit performance is profits as a share of GDP in current dollars. For the nonfinancial sector, this share amounted to 6.1% of GDP in 1997 and 3.9% in the third quarter of 2004. For the manufacturing sector, this share slumped from 2.5% to 0.9%, and for retail trade from 0.77% to 0.55%. This is a profit squeeze, rather than a profit miracle.

## **EASY FIRING IS BY NO MEANS A VIRTUE**

This leads to two other issues: *first*, the causes of the protracted profit squeeze; and *second*, future prospects. There is a general perception, particularly in the United States, that business profits are primarily determined by pricing power relative to aggregate expenses. Since pricing power is beyond the control of businesses, the consensus regards cost cutting as the essential way to improve profits. It is a badly flawed perception.

Another one is that wages represent by far the largest expense component of businesses. In reality, the biggest component by far is business spending on intermediate goods and services. But as the GDP counts only expenditures on final goods and services, they are excluded from the macro statistics. Nevertheless, they exist. In 2000, business spending on "intermediate inputs" (outside of GDP) amounted to \$8,369.6 billion, compared to a GDP of \$9,817 billion.

Trying to identify the main influences on profit generation ought to start with one very simple sentence: All business expenses reduce aggregate business profits; all revenues increase aggregate profits. But the complication, which economists in general completely ignore, arises from the fact that business revenues flow from very different sources.

To give one striking example: Labor costs can be reduced in two diametrically different ways. One is by firing people, and the other is through labor-saving investment. In America, the easy ability of firms to fire their employees is widely hailed as wonderful advantage to create profits. It is a gross and fatal error.

What is not understood in the United States (and elsewhere) is the fact that, looking at businesses as a whole, cutting wages implicitly reduces business revenues as well as business expenses. As wage earners spend their money on goods and services, they return their earnings to the business sector as revenue. But as businesses cut their spending on wages, they essentially cut the purchasing power of their employees for their products.

*In Europe and Japan, by contrast, labor costs have traditionally been reduced through investment in labor-saving machinery. This has two most important macro effects. It creates employment in the capital goods industries, and it boosts aggregate profits, because the investment spending increases overall business revenues. In fact, this is the secret why German and Japanese firms have outperformed U.S. businesses for decades. Easy firing is by no means a virtue.*

## **THE PROFIT SOURCES**

From the macro perspective, U.S. business profits received their main boost from two flows in recent years. One was the phenomenal decline of personal saving, and the other was the soaring budget deficit accruing from tax cuts and higher spending.

Saving is the unspent part of personal income. To this extent, wage earners reduce total business receipts in relation to total expenses incurred. The net result is a corresponding fall in profits. Conversely, when households run down their saving, business revenues rise in relation to expenses incurred. The net result is higher profits.

In this way, the phenomenal collapse of personal saving in the past few years has been Corporate America's main profit bonanza. This was far more important than the direct and indirect revenue flows from the soaring budget deficit.

But the trouble is that the soaring U.S. trade deficit in recent years has been diverting a rapidly growing share of such spending and its inherent profit creation to foreign producers. In essence, the trade deficit directly transfers spending and profits from domestic to foreign producers, leaving American producers with the wage expenses, which their employees spend on foreign goods. As we have stressed many times, the trade deficit is the greatest profit killer in the U.S. economy.

We come to the most important macroeconomic profit source in a healthy economy. Apparently unknown to most American economists, this is net capital investment. John M. Keynes expressed it with great simplicity and precision: *There are two streams of money flowing to the entrepreneurs, namely, the part of their incomes that the public spends on consumption and the expenditures of businesses on net capital investment.*

Economists, in general, are completely unaware of the crucial importance of business investment for business revenues and profits. This has a particular and peculiar reason. From the perspective of the business sector as a whole, investment spending creates business revenue without generating business expense.

What seems mysterious has, in reality, a simple explanation. Investing firms capitalize their investment expenditures. No expense is incurred until the first depreciation charge is recorded. For the producers of the capital goods, on the other hand, it involves a sale, producing immediate revenue.

*Due to this particular treatment in accounting, net fixed investment is typically the business sector's most important profit source. But in the United States, this profit source has dramatically collapsed in the past few years, as rising depreciations have overtaken gross new investment.*

In 2003, net fixed investment amounted to \$154.5 billion, after \$404.8 billion in 2000. This implies, *first of all*, a rapidly shrinking capital stock; and *second*, a disastrous drag on business profits, because depreciations are expensive.

Answering the question of aggregate profit prospects for the U.S. economy in 2005 requires a macro perspective focusing on changes in four aggregates: personal saving, budget deficit, trade deficit and net business investment.

Our crucial assumption is that negative profit influences will grossly outweigh positive influences, suggesting in their wake lower business investment. If the consumer starts to save out of current income, the U.S. economy will slump.

## **BUBBLE DEFLATION**

We have characterized the U.S. economy as a bubble economy in the sense that asset appreciation has become its main engine of growth. Courtesy of the prolonged sharp rise in house prices, the American consumer has been

willing and able to maintain his spending despite a protracted recession in employment and wage incomes.

But we see a variety of influences tempering the bubble climate. For the time being, the whole set of asset bubbles finds strong support from still exceptionally low short-term rates, still extremely loose money and credit, and high-riding expectations about strong U.S. economic growth and low inflation rates in 2005. Many economic data warn of impending strong disappointment on both counts that will prick the bubbles. Not to ignore, moreover, the Fed's commitment to further rate hikes.

Yet the refusal of long-term rates to rise in response to the Fed's serial exertions to raise short-term rates further is perplexing. Mr. Greenspan himself spoke of a "conundrum." A reported inflation rate above 3% would, by past experience, imply a federal funds rate of at least 5%. But a rate of 3.5% would already be enough to wreck the bond bubble, and in its wake, the stock and housing bubbles.

For sure, the financial community is fully aware of this immense policy risk, strictly limiting the Fed's scope for further rate hikes. The amazing stability of long-term rates suggests the financial community has not only refused to unwind, but has even continued to add to existing carry-trade positions. They are still far too profitable to be abandoned before the Fed makes them unsustainable.

As no one is taking the Fed seriously, it may have to do more than it wants. The frightening point to see is that, given the U.S. economy's heavy dependence on consumer spending for the housing bubble, a mere leveling of house prices would be enough to slash consumer spending and economic growth. We expect worse than price stagnation.

It ought to be realized that a rise in long-term rates by only 1–2 percentage points would rapidly play havoc with all existing asset bubbles — bonds, stocks, housing — and in consequence, with economic growth. Within a matter of months, there would be deep recession.

A crucial question is the inherent impact on personal saving. Voluntarily or involuntarily, private households will sharply restrain their borrowing and return to old-fashioned saving out of their current income. That this will badly depress consumer spending needs no explanation. Unfortunately, when consumption declines, fragile business and housing investment will fall as well.

## **STRUCTURAL DRAGS**

Most people inside and outside of America have yet to realize two things: *first*, that among industrial countries, the U.S. economy has by far the worst structural fundamentals; and *second*, that it is far more vulnerable today than in 2000–01.

Of course, American policymakers and economists have been trumpeting the opposite for years. Having realized their complete disregard of macroeconomics, we are sure that they earnestly believe this fairy tale. With this in mind, we recently, with great interest, read a report from Morgan Stanley about a meeting with customers in late January.

About global economic prospects for 2005, it said: "*There was little doubt as to who would take the baton in a post-U.S.-centric world — it would be another encore for America. There was deep conviction that no one comes close to having such an ideal system — especially in terms of technology, the work force and America's unique risk-taking culture. Market depth and flexibility — in both the financial and the nonfinancial realms — was depicted as the icing on the cake for yet another run of U.S.-centric global growth.*"

Later, it stated, "*Europe, which has none of these qualities, is the last place where productivity could take off.*"

*For us, this is typical Wall Street trash, bare of any serious macroeconomic thought. It used to be an elementary truism among economists that a healthy economy is rich in savings, rich in productive investment and rich in profits. The U.S. economy is extremely poor in all three. But it is extremely rich in financial speculation and corporate malfeasance.*

To be sure, the enormous structural deficiencies are increasingly impairing U.S. economic growth. For the past three years, unprecedented monetary and fiscal profligacy has been able to overpower their depressant influence through the bubble-driven consumer borrowing-and-spending spree. Yet the “structural drags” are finally gaining the upper hand over the weakening bubble impetus. The U.S. economy’s famous resilience had more to do with clever statistics and unprecedented monetary looseness than with true economic strength.

## **UNREASONABLE ADJUSTMENTS**

Back to the statistical intricacies. Our first bone of contention with the BLS, long ago, was about hedonic pricing of computers. For many years, this letter was a lonely voice against this practice, for strictly economic reasons.

Though changes in computer power may be one important aspect, knowledge about actual business expenses and revenues is even more important. These huge amounts of hedonic dollars are purely fictional dollars, which nobody pays and nobody receives. Productivity effects should, in any case, show in the use of the computers, not in their purchase.

These and other considerations lead us to a general strict rejection of converting quality improvements statistically into price reductions. Constant quality improvements are an integral part of permanent economic progress.

Consumer satisfaction may be one aspect, but what matters far more, from a strictly economic perspective, is the money the consumer actually spends and which is no longer available for other spending purposes. Besides, the consumer cannot opt for the product without the quality adjustment.

Last but not least, these U.S. practices in calculating inflation rates grossly distort international comparisons of U.S. real GDP and productivity growth. These strictly economic considerations, in short, long ago led us to the conclusion that the practices the BLS uses to lower the reported U.S. inflation rates are unreasonable.

Meanwhile, arbitrary hedonic adjustments have reached a breathtaking scale. Spending on computers remains the single most important item, although the BLS tries to hide it by suppressing the numbers in real terms. But according to the quantity index for GDP growth, business investment in computers is up by 113.4% since 2000. This compares with a minimal increase in current dollars from \$101.4 billion to \$110.8 billion; that is, by 9.3%.

The truth, of course, is that both Mr. Boskin and Mr. Greenspan, the two main proponents behind these adjustments, had their specific reasons to want lower inflation rates. Mr. Boskin’s explicit intention, which he never made a secret, has been to lower government spending on inflation-tied Social Security.

*For Mr. Greenspan, the lowest possible inflation rate is a must for two reasons: First, by boosting the reported real GDP and productivity growth, it conveniently confirms his propaganda of a “new paradigm” U.S. economy; and second, it helps to justify the Fed’s wide-open money and credit spigots.*

## **MORE OF THE SAME**

Reported inflation rates are the one statistical aggregate to which America’s public and financial markets are most sensitive. The unemployment rate and employment growth are the others. Here, too, the BLS has developed increasing creativity in delivering better-looking numbers.

During the Kennedy administration, the BLS invented the concept of the “discouraged worker.” Asking people whether they are unemployed, the surveyor further poses the question of whether the person has been actively seeking a new job. If the answer is no, he no longer counts as unemployed, but disappears from this category as a “discouraged worker.”

This statistical treatment plainly lacks any common sense. It can surely be assumed as a rule that most of those

people have come to regard such a search as hopeless after repeated disappointing experience. Most probably, they are in reality the worst cases among the unemployed. Including several million “discouraged workers,” the U.S. unemployment rate would today be between above 7%, rather than 5.2%.

Now to the statistical deus ex machina, which gave employment its decisive big boost in 2004 — the computational “net birth/death” model. During the first half of last year, the BLS suddenly stunned the markets with sharp jumps in its payroll figures. For the three months ended in May, these soared by more than 300,000 for each month.

Apparently indicating sharply accelerating economic growth, it promptly stopped the euro’s incipient rally; and remarkably, it was quickly followed by the Fed’s decision to increase its fed funds rate over a prolonged period.

It is the declared function of this computer model to capture employment growth generated by new business formation. During the three months to May, this model created 618,000 new jobs, 206,000 each month. That is, the big jump in new jobs had overwhelmingly accrued from this computational change, and not from the regular survey. Before 2000, this adjustment for new business formation was fixed at 35,000 each month.

The BLS has never explained how it has arrived at the new, staggering numbers. If there is any reasonable basis, it must essentially be the job experience in past recoveries. But as our chart on Page 2 reveals, the present economic recovery differs in terms of employment growth from past experience like day and night. To assume that a collapse of job creation, as measured by the regular surveys, is accompanied by booming job creation through new business formation is an absurdity.

We have to add that the recorded job growth is by no means the end of this abject story. Implicitly, the Bureau of Economic Analysis translates the job numbers it gets from the BLS into corresponding increases in wage and salary income.

## **IMPUTATION MAGIC**

If you want to see another most amazing thing, take a look at Table 7.12 of the BEA report *Imputations in the National Income and Product Accounts*. It tells us that of a total U.S. GDP of \$11 trillion in 2003, a little over \$1.6 trillion — or around 14.5% of the total — is “imputed.”

In 2003, total disposable income of private households amounted to \$8.1 trillion. Of this sum, \$873 billion, or 11%, had accrued from such imputations. Putting it differently, in terms of cash, their income, as reported in the National Income and Product Accounts, is overstated by this sum. Taking this into account, the personal savings rate is disastrously negative.

What is an imputation? It means specific components of GDP or national income that the statisticians add by estimate because they see spending or benefits that have involved no cash payments. This BEA table shows, in detail, a long, long list of imputed income or spending — too long for us to count.

## **TRADE MAGIC**

We have repeatedly written about these various devices, which deliberately aim to lower the reported inflation rates, always emphasizing that this implicitly raises real GDP and productivity growth. Recently, while reading reports about soaring U.S. high-tech imports from China, we had second thoughts about their potential effect on reported U.S. real GDP and productivity growth.

U.S. imports of advanced technology products are running at well over \$200 billion per year, exceeding exports last year by \$37 billion. Plainly, cheap imports cover a very large part of high-tech spending in the United States.

But now comes the salient point. Imports of high-tech goods enter the U.S. GDP calculation at their actual, low prices. Domestic spending on high-tech goods, in contrast, enters the same calculation at the elevated level of

hedonic pricing. Imports subtract from GDP; domestic spending measured with hedonic pricing inflates GDP. The net effect is inflated U.S. real GDP and productivity growth.

On March 26, 2004, Goldman Sachs published a brief study in *U.S. Economic Analyst* under the title “Has Outsourcing Inflated the GDP Numbers?” The author enumerates several reasons why reported U.S. real GDP growth appears significantly overstated. He points to a probable heavy distortion through internal outsourcing of services by U.S. multinationals.

The study notes: “*When U.S. firms outsource call-center and IT-support jobs to India and other Asian countries, this should result in higher service imports. But the official U.S. statistics show little sign of such an increase in the past few years. For example, the U.S. statistics show \$661 million of professional service imports from India in 2002, but the Indian software industry association NASSCOM thinks India exported \$6.6 billion in software and other similar services to North America.*”

## **HOW BIG A LIE?**

The big question, essentially, is the effect of these hedonic substitution adjustments in lifting real GDP and productivity growth through a lower inflation rate. Although the CPI is not used in the GDP calculation, there are, of course, close relationships. It goes without saying that the lower the calculated inflation rate, the higher the inflation-adjusted rate of GDP growth.

Pondering the true magnitude of this effect, it caught our attention that the prices of consumer durables are in a free fall. During 1995–2000, their overall price index fell 8%. While its “motor vehicles and parts” component edged up 1.6%, the “furniture and household equipment” component plunged by 20.7%. During 2000–04, the overall index for consumer durables plummeted by 9.6%, of which autos made up 4% and household equipment 20%.

To be sure, this is abundant hedonic pricing, rather than savage deflation, at work. These declines compare with a 16.4% rise in the CPI over the same two periods, a total of nine years. Importantly, consumer durables accounted for 23% of real GDP growth during this period.

A committee of the Conference Board put the statistical effect of the inflation adjustments related to the recommendations of the Boskin Commission at 1 percentage point of the CPI. For sure, this institution warrants a very cautious estimate. Still, that was already enough to transform ordinary real GDP and productivity growth into spectacular growth.

But that leaves us with the other major effects that we exposed — cheap rent for homeownership, the missing imports from outsourcing and the hedonic pricing effects of cheap high-tech imports.

We have no idea by how much these three effects have contributed to the overstatement of U.S. real GDP growth in the past few years. For sure, they were significant in the aggregate. An extremely cautious estimate would put them at 0.5 percentage points per year, at the very least. Together with the 1 percentage point attributed to the implementation of the Boskin proposals, this adds up to 1.5 percentage points per year and 6 percentage points over the four years since 2000. We regard this as a very cautious estimate, reducing U.S. real GDP growth over this period from 10.4% to, broadly, 4%.

## **UNITED STATES VERSUS EUROZONE**

Over the four years 2000–04, U.S. GDP growth has been reported as 19.5% in nominal terms and 10.4% in real terms. The underlying GDP deflator rose 8.2%, or 2.05% per year. For the eurozone, reported growth of GDP over this period is 14.4% in nominal terms and 4.8% in real terms. The underlying GDP deflator increased 9.7%, or 2.4% each year.

As a matter of fact, we take all such numbers with a grain of salt. In the U.S. case, though, for the reasons

explained, we need a handful of salt. Conservative estimates put the understatement of inflation at 1% each year. Taking all the other distorting influences, as explained in detail, into account, we come to an understatement of the domestic inflation rate by at least 1.5% each year. It may be 2% and higher.

This means that the U.S. economy has by no means outperformed the eurozone. It has lagged it. As a matter of fact, it has grossly lagged in job creation. The real test of true prosperity is what happens to employment, incomes, saving and productive investment. Forget about the phony wealth creation through rising house prices. On those four counts, the U.S. economy is the worst performer in the world. The eurozone, by the way, has created 3.1 million new jobs since 2000.

## **U.S. BUBBLE ECONOMY**

Yet the most important difference between the U.S. and eurozone economies looms in a circumstance that most people find too delicate to mention. The United States has a bubble economy; the eurozone does not. It has asset bubbles, but there is no bubble economy.

What, first of all, is the key characteristic of an asset bubble? It implies that a sharp rise in asset prices derives from highly leveraged purchases financed by borrowing at low short-term rates. The decisive distinction is between credit-driven and savings-driven asset appreciation. In a country without savings of its own, like the United States, asset markets as a whole qualify as bubbles virtually by definition.

And what are the key features of a bubble economy? There are actually two of them. It implies, *first*, that asset owners, to a large extent, convert appreciating asset prices into a borrowing-and-spending binge; and *second*, that the credit excess enacts a major structural change in the economy's pattern of demand and output growth. In the U.S. case, it has overwhelmingly boosted consumption at the expense of business investment and the trade balance.

There is understandably a general reluctance to speak of the U.S. economy as a bubble economy, because it would flatly disavow all the talk about its superior efficiency. For many, it is tantamount to blasphemy. The unspoken truth is that it is the biggest bubble economy in history, lasting already much longer than Japan's bubble economy of the late 1980s.

## **CONCLUSIONS**

An economy must decline in its entirety so long as more is consumed than produced, as Mr. Hayek says in the introductory quote. But this has become the U.S. economy's long-term growth pattern. Recognizing this fact is basic for our critical assessment of the economy's recent development. The dismal reality is deceptive wealth creation through asset bubbles on one hand and accelerating erosion of the economy's productive base on the other.

Never before has an economy in recession been treated with such massive monetary and fiscal stimulus as the United States this time. Yet what has resulted has been a recovery that is the single worst on record in terms of generating the real (inflation-adjusted) growth in wage and salary income that determines most people's living standard.

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